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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY,
AND
PENNSYLVANIA POWER COMPANY Appellants,

V.

DAVID M. BARASCH, CONSUMER ADVOCATE, et al.
Appellees.

On Appeal from the
Supreme Court of Pennsylvania

BRIEF FOR THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether a state may constitutionally require utility property to be used and useful in providing service to ratepayers before the property is included in the utility's rates?

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INTEREST OF AMICUS CURIAE

The National Association of State Utility Consumer Advocates (NASUCA) files

this brief as amicus curiae in support of appellees. NASUCA members represent electric consumers in thirty-seven states and the District of Columbia. NASUCA urges this Court to affirm the decision of the Supreme Court of Pennsylvania. A reversal will have a dramatic, immediate, and negative impact on the traditional scope of state regulation of investor-owned public utilities. Those participating as consumers and advocates for consumers in a changed state regulatory process will be detrimentally affected. NASUCA submits this brief with the consent of the parties, and files written verification of this with the Clerk pursuant to Supreme Court Rule 36.2.

SUMMARY OF ARGUMENT

A monopoly status was granted to electric utilities in the belief that these

utilities were natural monopolies. In return for the privileged monopoly status, electric utilities are subject to government regulation. The purpose of regulation is to be a surrogate for competition in determining just and reasonable rates. In fulfilling its function, regulation must balance the conflicting interests of both the consumer and the investor.

To accomplish this difficult task, regulation has developed certain regulatory principles. Perhaps the most important of these principles is that rates must be determined only on a utility's investment actually providing a service to the ratepayer. The exclusion of property not used and useful from a utility's rates results in an equitable allocation of

risks between consumers and investors, and is necessary in order to provide incentives to a utility to operate efficiently.

This Court has never interpreted the Constitution to establish an investor right to receive a profit on property that has no value in serving the public. The Pennsylvania Supreme Court's decision in upholding a Pennsylvania law prohibiting the inclusion of cancelled plant in a utility's rates was proper. Cancelled plant has no value and the recognition of this obvious fact is entirely appropriate. This Court has ruled many times that due process only prevents destruction of value by government action and cannot be applied to restore values that have been lost by the operation of economic forces.

ARGUMENT

THE REGULATORY PRINCIPLE OF USED AND USEFUL IS A CONSTITUTIONALLY VALID REGULATORY TOOL.

A. UTILITIES ENJOY A PRIVILEGED MONOPOLY STATUS

This Court in United Fuel Gas Co. v. Railroad Commission of Kentucky, 278 U.S. 300, 309 (1929), observed that a regulated public utility exercises an extraordinary privilege and occupies a privileged position as compared to other profit motivated private enterprises. Under regulation a public utility is granted a monopoly status and is sheltered against many of the hazards to which the unregulated business is subject.

History shows that as the electric industry developed in this country, individual state legislatures gradually determined that electric companies were natural monopolies and that it was in society's interest to grant them a monopoly status. It was widely believed that competition between electric companies could interfere with efficient supply of the service. At the same time, the economics of producing electricity, at least in the early days, indicated that the industry was on a decreasing cost basis - the more a company produced the less its cost of production.

In this context legislators disregarded one of the basic premises of a free enterprise system: that free competition resulted in the best allocation of society's resources and resulted in a

fair price for an adequate output of goods. They allowed electric companies to become monopolies. In utility regulation the privileged monopoly status is conveyed to the private utility in return for the utility's obligation to provide reliable service to the public.

However, government regulation was needed to offset the natural tendency of a monopoly to be inefficient and exhibit other behavior inimical to the public interest, i.e., reducing output in order to extract a higher price. Therefore electric utilities, in return for their state created monopoly status, are regulated by the state.

The goal of utility regulation is to determine rates that would result from free competition if free competition were possible. The regulator has the difficult

and complex role of determining rates that are just and reasonable from both the captive ratepayer and investor perspectives.

The interest of the consumers in receiving the best service at the lowest rates possible and the profit motive of the investor are at odds in this case. The public interest in not being required to pay for something that will never have any value to them nor ever be useful to any segment of society, far outweighs the investor interest in receiving a profit on a failed investment. The Pennsylvania legislature and the Pennsylvania Supreme Court concluded similarly.

Regulators have to balance these interests in a continually changing economic atmosphere. Generally speaking,

though, a utility is entitled to rates which provide an opportunity to yield revenues sufficient to meet operating expenses, taxes, and provide a fair return on its rate base. Rate base is defined as the dollar value of a company's plant and equipment that is serving the public. Iowa-Ill. Gas and Electric v. Iowa S. Com Comm'n, 347 N.W.2d 423 (Iowa 1984). A utility is entitled to a reasonable profit or rate of return on this used and useful property, so long as it was procured under conditions of prudent and efficient management.

Rate of return is the cost to the utility of its financing incurred to produce its plant and equipment. Rate of return has three components - cost of debt, preferred stock, and equity or common stock. In any determination of rate of

return, the cost of debt and preferred stock are fixed amounts and their values can be determined by simple arithmetic. The cost of equity basically determines the profit the utility will be allowed to earn. By its very nature this determination is subjective and depends upon what regulators perceive to be a fair return or profit on investment. Implicit in an allowed rate of return is a risk premium. The risk premium compensates the investor for the risk that his investment may be unsuccessful.

Within the context of this ratemaking formula, regulation has to fulfill its function as a substitute for competition. Regulation must not only prevent the utility from charging excessive rates, impairing the quality of its service and

earning excessive profits; but it must also provide incentives to improve quality and to increase efficiency. Even though this goal of regulation is clear and indisputable, achieving it is extremely difficult. Regulatory agencies can neither acquire nor effectively utilize the range of data which influence a competitive market.[1] The difficulties of regulation are largely inherent in the nature of the undertaking itself. "It cannot prescribe quality, force efficiency, or require innovation, because such action would invade the sphere of management. But when it leaves these matters to the discretion of industry, it denies consumers the protection that competition would afford."[2]

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1 Phillips, The Regulation of Public Utilities: Theory and Practice (1985) at 154, quoting from former FCC chairman, Lee Loevinger, Regulation and Competition as Alternatives, 11 The Antitrust Bulletin 101, 125 (1966).

2 Wilcox, Public Policies Toward Business (3d ed.), at 476-77.

B. THIS COURT, STATE SUPREME COURTS, AND REGULATORY BODIES CONSTITUTIONALLY UTILIZE THE USED AND USEFUL PRINCIPLE.

Realizing that public utility regulation is inherently incapable of supplying the kind of continuous pressure and incentives for the efficient operation of a utility that competition ordinarily supplies in non-regulated industries, several states have developed regulatory principles to compensate for the lack of competition. One widely accepted principle is that rates must be determined only on an investment actually providing a service to the ratepayer or on property that is used and useful. The used and useful principle balances the interests between the ratepayer and investor by protecting the consumer from unnecessary or excessive investment while allowing investors a

return on the capital which they have reasonably devoted to public use. The used and useful test serves to measure precisely how much property is devoted to the public for which a return can be expected. Beginning with Smyth v. Ames, 169 U.S. 466 (1898), this Court found that a utility is entitled to a return upon that property which is used and devoted by it to the public convenience. On the other hand, property which is not used and useful for the public convenience is not to be included as a basis for making rates. Denver Union Stock Yard Co. v. United States, 304 U.S. 470, 475 (1938). The used and useful test has been accepted by the vast majority of jurisdictions as a means of distinguishing between property included in rates and property appropriately excluded.

Some jurisdictions apply the used and useful test in conjunction with the requirement that the investment be

prudent.[3] With respect to the prudence requirement, it is clear that ratepayers are not to be charged for negligent, wasteful or improvident expenditures, or for the cost of management decisions which are not made in good faith. Reagan v. Farmers' Loan & Trust Co., 154 U.S. 362, 412 (1894). Ratepayers are not expected to pay for management's lack of honesty or sound business judgment. Missouri ex rel. S.W. Bell Tel. Co.v. Pub. Serv. Comm., 262 U.S. 276, 290 n.1 (1923) (Brandeis, J. concurring). This Court has never held, however, that a utility reglatory agency is limited solely to a prudence analysis. Communications Satellite Corp. v. FCC, 611 F2d 883, 890 (D.C. Cir. 1977).On the

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3 The prudent investment test is widely credited to Mr. Justice Brandeis. Whether he intended to limit a regulatory body to this test is questionable. He developed this test with the history of the railroads in mind. As he explained, this history was replete with examples of fraud on ratepayers. See infra note 8.

contrary, it is simply one of several tools available to the regulator.

Even if the prudence test is used, the investigation into what property should be included in rates cannot realistically end with that analysis as appellants argue. A competitive market does not differentiate between prudent and imprudent investments. The market provides rewards and penalties based on the result of the investment decision. In a competitive market, firms that cancel partially completed plants for lack of demand do not recover their investments. The harsh consequences of misjudgments in the competitive market provide powerful incentives for prudent decisionmaking.

Moreover, this Court has long held that prudently incurred property could be excluded from rates. In Los Angeles Gas and Electric Corp. v. Railroad Commission of California, 289 U.S. 287 (1933), the

Court considered whether a plant designed to manufacture natural gas which was no longer in use should be included in rate base. The Court noted:

> The time and circumstances of the outlay, and the effect of altered conditions, demand consideration. Even when cost is revised so as to reflect what may be deemed to have been invested prudently and in good faith, the investment may embrace property no longer used and useful for the public.

Id. at 306.

Similarly, in Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575 (1942), where natural gas producers alleged that the exclusion of excess plant capacity from rate base was confiscatory, the Court stated that there was no constitutional right to the inclusion of this value as a separate item. Rather, it is "only on the

assumption that excess capacity is a part of the utility's equipment used and useful in the regulated business, that it can be included as a part of the rate base on which a return may be earned." 315 U.S. at 590. Also, in Permian Basin Area Rate Cases, 390 U.S. 747 (1968), producers of natural gas attacked the Federal Power Commission's failure to include an adequate allowance for exploration costs. Rejecting the claim outright, the Court stated: "We must emphasize that we perceive no obligation upon the Commission, under the Constitution or the Natural Gas Act, to permit recovery of all exploration costs, regardless of their amount and prudence." 390 U.S. at 825 n.115. Indeed, in Market Street Railway Co. v. Railroad Commission, 324 U.S. 548 (1945), this Court rejected the proposition that every prudent

investment must be included in rates. 324 U.S. at 567. See also infra at 40-42; Denver Union Stock Yard Co. v. United States, 304 U.S. 470, 476 (1938).

In Tennessee Gas Pipeline Co. v. Federal Energy Regulatory Commission, 606 F.2d 1094 (D.C. Cir. 1979), the issue was whether FERC had properly excluded certain investments from rate base. The Court asserted that the investment must be used and useful. "These investments were prudent investments, argues Transco; however, for rate base inclusion expenditures must satisfy not only the necessary condition of prudent investment but also must be 'used and useful' in providing service." Id. at 1123. Accord, NEPCO Municipal Rate Committee v. Federal Energy Regulatory Commission, 668 F.2d 1327, 1333 (D.C. Cir. 1981).

Many state courts and commissions have recognized the validity of the used and useful test in addition to an analysis of prudency.[4] Typical of the analysis is

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[4] Iowa-Ill. Gas and Electric v. Iowa S. Com Comm'n, 347 N.W.2d 423, 429 (Iowa 1984); Madison Gas and Electric Co. v. Public Service Commission of Wisconsin, 325 N.W.2d 339 (Wis. 1982); Philadelphia Electric Co. v. Pennsylvania Public Utility Commission, 61 Pa. Commw. 320, 433 A.2d 620 (1981); Public Service Commission v. Montana-Dakota Utilities Co., 100 N.W.2d 140, 150 (N.D. Sup. Ct. 1959); Re Kansas City Power and Light Co., 75 PUR 4th 1, 125 (Mo. Pub. Serv. Comm'n. 1986); Pa. PUC v. Pennsylvania Power and Light, 67 PUR 4th 30 (Pa. Pub. Util. Comm'n. 1985); Arkansas Power and Light Co., 66 PUR 4th 167, 183 (Ark. Publ. Serv. Comm'n. 1985); Washington Utility and Transportation Commission v. Pacific Power and Light Co., 51 PUR 4th 158, 167 (Wash. Ut. & Tr. Comm. 1983); Re Consumers Power Co., 14 PUR 4th 1, 15 (Mich. P.S.C. 1976); Re Tampa Electric Co., 92 PUR 3d 398, (Fla. P.S.C. 1971); Re The Chesapeake and Potomac Telephone Co., 57 PUR 3d 1, 6 (D.C. P.S.C. 1964); Mayor of City of Everett v. Malden and Melrose Gas Light Co., 78 PUR (NS) 129, 132-33 (Mass. D.P.U. 1949); City of Bend v. Bend Water, Light, and Power Co., PUR 1915F 913, 917 (Ore. P.S.C. 1915).

Re Iowa-Illinois Gas and Electric Co., 46 PUR 4th 616 (Iowa S.C.C. 1982). There the Iowa Commission expressly rejected sole reliance upon the prudence standard urged by the utility.

> The "prudency" test Iowa-Illinois advocates would, taken to its logical extreme, require us to allow Iowa-Illinois a full return on any amount of capacity, regardless of the consequences to the consumer, so long as the decision to invest in that amount of capacity was justified at the time it was made. We do not believe the prudency test Iowa-Illinois advocates is consistent with sound regulatory principles.

Id. at 618.

In cases like the instant one involving cancelled plants, the used and useful principle is indispensable to protect consumers. The Supreme Court of Indiana, in Citizens Action v. Northern Indiana Public, 485 N.E.2d 610 (Ind. 1985),

noted the long-standing history of evaluating property that is used and useful in rate base. Id. at 614. Upholding the disallowance of cancelled plant from rate base, the court said:

> [W]e have been unable to conceive of a situation ... in which the consumers could be required to replenish lost capital which had never become "used and useful" property or, in other words, be required to act in aid and support of the utility as an insurer of the investor's risk, unless consumers received an interest in return which provided an opportunity to earn a return on the capital supplied.

Id. at 615.

The foregoing history establishes that the used and useful standard is key to determining rates that balance ratepayer and investor interests. Appellants' argument to the contrary is simply without merit. Although the prudence standard may be appealing in theory, it is extremely unfair to limit a regulatory body solely to

that standard. There are practical problems with it, beyond proper regulatory principles, that militate against the sole application of the prudence standard. Demonstrating the prudence and/or imprudence of a utility's decision to construct a new plant requires enormous expenditures for expert witnesses. Generally litigation costs of this magnitude are beyond the reach of most consumer groups and regulatory bodies. Even the Federal Energy Regulatory Commission (FERC) has noted that it does not have sufficient resources to determine whether a utility has acted prudently in deciding to build a particular plant.[5]

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5 Pierce, The Regulatory Treatment of Mistakes In Retrospect: Cancelled Plants and Excess Capacity, 132 U. Pa. L. Rev. 496, 512 nn.80, 81 (1984). Even in light of this Court's decision in Mississippi Power and Light Co. v. State of Mississippi on June 24, 1988, FERC's responsibility to conduct prudence reviews remains unclear and may require Congressional action.

Additionally, in regard to a utility's decisions in constructing a new plant, regulatory review may not occur until ten or fifteen years after the decision. This length of time makes it extremely difficult to gather the data and evidence necessary to show imprudence as well as prudence.

The other argument by the appellants and amici for them that the used and useful principle can only be applied in conjunction with the fair value method of determining rate base is spurious. They cite no authority for this proposition because this distinction has never been made in any of the numerous cases which applied the used and useful standard. The basis of the argument seems to be that a fair value rate base enables a utility the opportunity to earn more dollars and thereby be compensated for any potential used and useful disallowance.

This perception is false. History shows that a fair value determination could either increase or decrease the value of a utility's rate base. The value will constantly fluctuate in accordance with economic cycles and trends. Given a different economic climate, appellants might have to change their position and argue that the used and useful standard can only be applied to original cost.

It was precisely because of the difficulty in determining fair value that this Court discarded this imprecise valuation, and ruled that it would no longer be constitutionally mandated. Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944). The Court wisely removed itself from a debate that one commentator at the time described as follows:

> The subject of valuation in the regulatory field probably has engendered more disagreement and contrariety of opinion, and has strained more friendships, than any other subject with the possible exceptions of religion, politics and the keen dispute over the authorship of the works attributed to William Shakespeare. One might say, with the full support of regulatory history, that valuation comes close to what might be truly characterized or described as institutionalized uncertainty.[6]

The exclusion of property not used and useful results in an equitable allocation of risks between consumers and investors, and provides adequate incentives for efficient operation. The utility's profit stems from receiving a rate of

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6 McKeage, Public Utility Regulatory Law 63 (1956).

return on its rate base: the larger the rate base, the higher the potential profits for the utility. This results in a natural incentive for utilities to build large, capital intensive plants.[7] The most dangerous problem of including plant not used and useful in rate base is that it perpetuates this inappropriate incentive. If a utility knows that its investments in future plants will be included in rate base even if cancelled prior to completion, it is more likely that the utility will fail to exercise sufficient caution in planning its construction program. A return on cancelled plant removes a necessary constraint on a utility to control the costs and size of a construction program. Regulatory bodies that utilize a used and

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7 Pierce, supra, at 506; Schwartz, Inflation and Utility Rate Regulation, 4 Utah L. Rev. 89, 93 n.9 (1982)

useful test are fulfilling their obligation to determine fair and reasonable rates in light of their role as surrogates for competition.

C. HOPE: ITS PREDECESSORS AND PROGENY DO NOT ESTABLISH A CONSTITUTIONAL RIGHT TO RETURN OF OR ON PROPERTY THAT IS NOT USED AND USEFUL.

The statute at issue here, 66 Pa. Cons. Stat. § 1315 (1982), like many state statutes and regulatory practices, disallows the cost of any plant not used and useful. Appellants allege that the statute and the Pennsylvania Supreme Court's intrepretation of the statute amounts to a taking of the utility's property in violation of the 5th Amendment of the United States Constitution. A review of the cases before this Court

establishes that the denial of these costs does not rise to the level of a "taking."

In 1877, in Munn v. Illinois, 94 U.S. 113 (1877), this Court upheld the right of the State of Illinois to regulate the prices charged to farmers for the storage of grain in grain elevators. The Court there recognized that the public interest may override the interests of private enterprise. In Munn, a small number of elevator operators had a "virtual monopoly" and openly set uniform prices. 94 U.S. at 131. The Court held that businesses "affected with a public interest" were subject to control, i.e., price regulation, under the general police power in order to protect the public. 94 U.S. at 126.

Seventeen years later, in Reagan v. Farmers' Loan & Trust Co., 154 U.S. 362 (1894), the Court held that under the power

of eminent domain, if the state were to take the appellant's (here a railroad's) property, it would have to pay compensation. Similarly, taking the use of the property for public benefit at less than its market value was equally a taking. 154 U.S. at 410. The Court emphasized, however, that:

> It is unnecessary to decide, and we do not wish to be understood as laying down as an absolute rule, that in every case a failure to produce some profit to those who have invested their money in the building of a road is conclusive that the tariff is unjust and unreasonable. And yet justice demands that everyone should receive some compensation for use of his money or property, if it be possible without prejudice to the rights of others.

154 U.S. at 412.

Shortly after Reagan, in Covington & Lexington Turnpike Co. v. Sandford, 164 U.S. 578 (1896), the Court required turnpike rates high enough to pay dividends, but only if there was no proof that the public interest justified lower rates. There was no unconstitutional taking if the low rates reflected the value to the public of the company's service, the imprudence of investment, or losses caused by competition. 164 U.S. at 596-97.

The principles of Reagan and Sandford culminated in Smyth v. Ames, 169 U.S. 466 (1898). In Smyth, the Court reiterated the principle of Sandford that rates should reflect the value of service to the public. The Court rejected the plaintiff railroads' argument that would have required the regulators in setting rates to use the historical book value of the

railroad property, an amount far more than the reproduction cost of the railroad facilities because of the depressed economy of the late 1800's and because of excessive construction contracts, imprudent financing and watered stock.[8] Instead, the Court adopted a rule that set rates at a level that covered operating expenses and provided a "fair return" on the "fair value of property being used by it for the convenience of the public." 169 U.S. at 546, 547.

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8 Missouri ex rel. S.W. Bell Tel. Co. v. Public Service Commission, 262 U.S. 276, 298 (1922) (Brandeis, J., concurring); Drobak, From Turnpike to Nuclear Power: The Constitutional Limits on Utility Rate Regulation, 65 Boston U.L.R. 65, 77-78 nn. 52, 53 (1985).

> What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand is that no more be exacted from it for the use of a public highway than the services rendered by it are actually worth.

Id. at 546-47. Although the Court listed many factors to be considered in determining fair value, subsequent cases reduced those factors to the reproduction cost at the time of the rate hearing. See, e.g., Missouri ex rel. S.W. Bell Tel. Co. v. Public Service Commission, 262 U.S. 276, 290, 298 (1922).

While reproduction cost was favorable to the public as applied to inflated railroad construction costs during depressed economic times, the situation

reversed during the inflationary period of World War I.[9] In addition, replacement cost failed to be the definite, calculable number that regulating authorities had desired. These woes were eloquently voiced by Mr. Justice Brandeis in his concurring opinion in Missouri, ex rel. S.W. Bell Tel. Co. v. Public Service Commission, 262 U.S. 276 (1923) There he advocated laying to rest the Smyth reproduction cost rule and allowing the utility to earn "a fair return on the amount prudently invested in it." 262 U.S. at 289. While attacking the Smyth rule on the basis of its historical foundations, which were no longer applicable, and the fact that it

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9 Missouri ex rel S.W. Bell Tel. Co. v. Public Service Commission, supra note 8 at 299-301 (1923) (Brandeis, J., concurring); Drobak, supra at 81, n.8.

was unworkable in practice, Mr. Justice Brandeis also changed the constitutional inquiry from the prevailing eminent domain philosophy of taking the utility's property to that of taking the investors' capital. 262 U.S. at 290.[10]

> The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested the Federal Constitution guarantees to the utility the opportunity to earn a fair return.... The Constitution does not guarantee to the utility the opportunity to earn a return on the value of all items of property used by the utility, or any of them.

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10 Drobak, supra, at 82.

262 U.S. at 290. He defined a constitutionally adequate rate level as:

> The compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business. Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of capital, whatever the nature of the security issued therefore; the allowance for risk incurred; and enough more to attract capital.

262 U.S. at 291. While this measure was intended to eliminate the vagaries inherent in the Smyth test,[12] it made two

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12 Reproduction cost necessarily varies with the cost of labor, materials and capital and other economic conditions.

assumptions. First, it assumed that any investment, short of dishonesty or obvious waste, was prudent. "Every investment may be assumed to have been made in the exercise of reasonable judgement, unless the contrary is shown." 262 U.S. at 289 n.1. Second, it assumed that the property in question was being used to provide service to ratepayers.

> [T]he cost to the utility of the capital, required to <u>construct, equip and operate</u> its plant, should measure the rate of return which the constitution guarantees opportunity to earn [footnote omitted].... It would, when once made in respect to any utility, be fixed for all time, subject only to increases to represent additions to plant....

<u>Id</u>. at 306-07 (emphasis added).

The <u>Smyth</u> test, however, lingered until the 1940's, when the Court released

regulators from their obligation to use any one test in <u>Federal Power Commission v. Natural Gas Pipeline Co.</u>, 315 U.S. 575 (1942), and <u>Federal Power Commission v. Hope Natural Gas Co.</u>, 320 U.S. 591 (1944). Both cases involved the constitutionality of the Natural Gas Act of 1938, 15 U.S.C. §§ 717, <u>et seq.</u>, which allowed the Federal Power Commission to set rates to be charged for the sale of natural gas. In <u>Natural Gas Pipeline</u>, the Court held that "[t]he Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas." 315 U.S. at 586. Agencies could adjust to specific circumstances as long as they acted within their statutory authority, and as long as the final order, "viewed in its entirety," did not produce an arbitrary result, the Constitutional inquiry ended. <u>Id</u>.

Regulation "does not insure that the business shall produce net revenues." 315 U.S. at 590.

Shortly after, in Hope, where the company challenged a commission order reducing natural gas rates, the Court held that if the statutory requirement of rates that were "just and reasonable" under section 5(a) of the Natural Gas Act is met, judicial inquiry is at an end. 320 U.S. at 602. The end result, not the method used, controls. Id. The Court re-emphasized that price regulation may, indeed, reduce the value of property regulated. Reduction in value does not mean the regulation is invalid. Id. at 601, citing Block v. Hirsh, 256 U.S. 135, 155-57 (1921), and Nebbia v. New York, 291 U.S. 502, 523-39 (1934). Moreover, setting "'just and reasonable rates' involves a balancing of the investor and consumer interests." 320 U.S. at 603.

As the concurring opinion of

Justices Black, Douglas and Murphy noted in Natural Gas Pipeline, the correct principle was that announced in Covington & Lexington Turnpike Co. v. Sandford:

> It cannot be said that a corporation ... is entitled, as of right, and without reference to the interests of the public, to realize a given percent upon its capital stock.... [Whether] the rates prescribed are unreasonable and unjust to the company and its stockholders ... involves an inquiry as to what is reasonable and just for the public.

164 U.S. 579, 596 (1896) as quoted in Natural Gas Pipeline, 315 U.S. at 607-08. The Natural Gas Pipeline concurrence emphasized that the investor interest is not the only interest to be protected.

> The investor and consumer interests may so collide as to warrant the rate-making body in concluding that a

> return on historical cost or prudent investment though fair to investors would be grossly unfair to the consumers.

315 U.S. at 608.

The consumer interest was given additional emphasis one year after Hope in Market Street Railway Co. v. Railroad Commission, 324 U.S. 548 (1945). The Market Street Railway Company operated street cars and buses in San Francisco. Due to competition from expanding municipally-owned lines, Market Street's traffic and revenue began to decline. The company asked for, and got, in 1939, a fare increase from the area-wide 5 cent standard to 7 cents. 324 U.S. at 555. Except for an increase in traffic during war-time, service continued to deteriorate even with the increased fares. 324 U.S. at 556. The California Supreme Court affirmed an order

of the Railroad Commission of California reducing rates from 7 to 6 cents. 324 U.S. at 552-53. Before this Court, the company claimed the order was confiscatory under Hope because the Commission used a rate base of $7,950,000 (the price at which the company offered to sell its properties to the city). The company challenged the Commission's failure to use reproduction costs (approximately $29,000,000), historical cost, prudent investment, or capitalization bases, and the resultant operating losses to the company. 324 U.S. at 553-54. The return was not sufficient to "'assure confidence in, the financial integrity of the enterprise, so as to maintain its credit and to attract capital'" or to "'enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the

risks assumed.'" 324 U.S. at 566, citing Hope, 320 U.S. at 603. Of Hope, the Court stated that "[a]ll that was held was that a company could not complain if the return which was allowed made it possible for the company to operate successfully." 324 U.S. at 566. Moreover, due process only prevents destruction of value by government action.

> [I]t may be safely generalized that the due process clause has never been held by this Court to require a commission to fix rates on the present reproduction value of something no one would presently want to reproduce, or on the historical valuation of a property whose history and current financial statements showed the value no longer to exist, or on an investment after it has vanished, even if once prudently made, or to maintain the credit of a concern whose securities already are impaired. The due process clause ... has not and cannot be applied to insure values or restore values that have been lost by the operation of economic forces.

324 U.S. at 567 (emphasis added).

Finally, the principles of the due process clause as applied in utility rate-making cases were revisited in Permian Basin Area Rate Cases 390 U.S. 747 (1968), where this Court affirmed the practice of the Federal Power Commission in setting rates for natural gas by the area from which it originated.[12] Reiterating that value may be constitutionally reduced, the Court also recognized that regulation may constitutionally "limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness." 390 U.S. at 769, again citing Sandford. 164 U.S. 578, 596 (1896). No constitutional objection

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12 As a practical matter, individual rate proceedings involving more than 3300 producers was impossible. At the time of the decision, 570 producers were involved in 3,278 rate increase proceedings awaiting hearing and decision. 390 U.S. at 757 nn. 12, 13.

existed where the commission weighed the interests of individual producers (and their investors) against the consumer interests. 390 U.S. at 770.

This succession of cases illustrates that regulators are allowed wide latitude in determining the particular rates that are "just and reasonable" for any given area at any given time. Indeed, were this not so, utilities would seek review on Fifth Amendment grounds of every rate decision where there was a cost denial. On the contrary, as Hope made apparent, there is no constitutional right to any specific method of determining rates, nor is there any constitutional right to inclusion of any particular cost.

A number of state legislatures have found the inclusion of costs that are not used and useful in rate base to be an

unjust and unreasonable burde.. co place on ratepayers. As noted in Nebbia v. New York, price control is unconstitutional "if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt...." 291 U.S. at 539 The used and useful test is neither arbitrary, discriminatory, nor irrelevant. Nothing in Hope questioned the validity of this criterion for consideration in ratemaking.[13] Rather, that the reverse is true is clear from Market Street. Simply stated, there is no basis in the Constitution for a utility's claim that the cost of cancelled plant must be included in rates.

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[13] See, e.g., Jersey Central Power Co. v. Federal Energy Regulatory Commission, 810 F.2d 1168, 1175 (D.C. Cir. 1987)(en banc) (The used and useful principle is one of several permissible tools of ratemaking); Washington Gas Light Co. v. Baker, 188 F.2d 11 (D.C. Cir. 1950), cert. denied 340 U.S. 952 (1951).

The long-range consequences of allowing this due process attack would be to remove most of the risk from utility investment. The Court would become, in essence, a guarantor of utility investments. This would be especially true if the Court were to disallow the application of the used and useful test.

Moreover, ratepayers are captive; they must purchase a utility's product in order to meet basic needs. Investors are not captive. They may purchase stock in any company and receive the applicable risk premium for successful investments. Investors have been on notice for at least the forty years since Hope that there is no constitutional right to profits and that the consumer interests may outweigh investor interests in any given case. There is no need or reason to change that firmly established principle now.

CONCLUSION

For the reasons stated above, the judgment of the Supreme Court of Pennsylvania should be affirmed.

Respectfully submitted,

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